**Statement of**

**Lawrence F. Portnoy**

**Before the**

**Subcommittee on Commercial and Administration Law**
**Committee on the Judiciary**
**U.S. House of Representatives**

**Hearing on H.R. 4019**
**Relating to State Taxation of Non-Resident Retirement Income**

**December 13, 2005**

Mr. Chairman, Congressman Watt and distinguished Members of the Subcommittee: Thank you for the opportunity to testify on H.R. 4019.

I am Lawrence Portnoy, a retired partner of PricewaterhouseCoopers, LLP. I joined the tax department of Price Waterhouse (now PricewaterhouseCoopers) in 1964 and was admitted to the partnership in 1975.

During my years with the firm I served as a tax consultant for many large multinational clients and later was responsible for representing clients before the National Office of the Internal Revenue Service on accounting method change requests, accounting period change requests, ruling requests and requests for technical advice. I represented the firm when making comments to IRS and Treasury Department on proposed regulations.

From 1992 until my retirement in 2001 I served as Tax Matters Partner and Senior Tax Technical Partner. This involved setting policy for the firm on major client tax matters and having responsibility for planning and compliance (the filing of all required tax returns) for the firm's federal, state, local, and international tax matters. During this period I supervised the firm's implementation of the procedure to account for income earned by staff in nonresident states, withholding and reporting procedures, preparation of resident tax returns for staff claiming

credit for tax paid to nonresident states, and calculating any amounts to be paid by the firm to staff to assure that their tax cost is no greater than if they did not work temporarily in nonresident states.

As a result of my work in this area, I am very familiar with the laws regarding the taxation, both federally and at the state level, of individuals and other taxable entities. In this regard, I wish to express my concerns with the misunderstanding in the State Taxation of Pension Income Act of 1995, (P.L. 104-95), often referred to as HR 394. The purpose behind passage of the Act was simple: to prohibit state taxation of certain pension income by states in which the recipient was neither resident nor domiciled at the time of receipt. According to the December 7, 1995 Report of the Committee on the Judiciary of the House of Representatives, the bill was needed because a system permitting both the individual's state of residence and the states in which the individual had previously earned income to tax retirement income, would produce a burden on retirees that would be "all too often simply unreasonable."

The Act defines retirement income broadly and exempts all income from "qualified" pension plans as defined in the Internal Revenue Code, as well as income received under deferred compensation plans that are "non-qualified" retirement plans under the Code, but that meet additional requirements. While HR 394 as originally proposed did not exempt income from non-qualified plans, it was amended prior to passage to add the exemption (with certain caveats) to distributions from such non-qualified plans. The reason for including income from non-qualified plans was best expressed by Representative Vucanovich during the Hearing before the Subcommittee on Commercial and Administrative Law of the Committee on the Judiciary in June of 1995. She stated that "it is a question of fairness to make the law apply equally to all retirees."

After the enactment of HR 394, all of the states respected the exemption of non-qualified deferred compensation (as defined under the Act) from nonresident taxation to all retirees, irrespective of whether he/she was formerly an employee or a self-employed individual—until the past year or so. Now, the question of whether the law applies equally to all retirees is being

questioned by the states, "unreasonable" burdens are surfacing, and double taxation of such income is again likely. The major factor accounting for the lack of equal application is that some states are asserting that the exemption does not apply to retired partners, only to retired employees. These states are also asserting that, even if retired partners are eligible for the exemption from nonresident taxation, an additional requirement applies to non-qualified deferred compensation received by them. Specifically, they assert that, if a partnership plan has a formulary cap or a provision for a cost of living adjustment, it does not qualify for the exemption, since the payments do not meet the Act's definition of "substantially equal periodic payments."

Why do we now have a problem? While the law was intended to apply to all retirees, due to what I believe is a misreading of the section of HR 394 exempting non-qualified plan benefits only where such benefits are paid pursuant to Section 3121 (v)(2)(C) of the Internal Revenue Code, some state taxing authorities maintain that the exemption is only available to employees. This section is a part of the Code relating to the Social Security and Medicare tax payments that employers and employees make under FICA. Partners, as self-employed individuals, make their payments of Social Security and Medicare taxes under a different section of the Code. However, nowhere does HR 394 use the word "employee." All references are to individuals and a reasonable interpretation would be that the reference to Section 3121 (v)(2)(C) was meant only to generally describe the type of non-qualified plan subject to the exemption – not to restrict the exemption to employees and allow the taxation of those who were self-employed.

This disparity in the treatment of retired partners raises a major issue with regard to "fairness" in that, unlike employees, partners of large accounting and law firms paid tax in as many as thirty or more states because that is where the partnership did business rather than where the individual performed services. These partners did not reside in these states and, in many instances, performed no services in the vast majority of these states. They were taxed under state partnership rules and received no benefits from the states either as residents or as income earners.

In most cases, the partnership filed both a partnership return and a composite return that included all partners who elected to be part of the return. The firm determined the income allocable to the state based on the firm's federal taxable income and the specific state apportionment formula. That total was then allocated to each partner. The composite return was filed for non-resident partners in lieu of individual returns filed by each nonresident partner and was based on the partner's distributive share of the firm's income earned in the state – whether the individual partner had worked in the state or had never stepped foot in it. In contrast, employees generally worked in only a few states during their active careers and actually earned income in such states and enjoyed the benefits as income earners in the states.

With regard to the issue of burden, it is clear that a system that would require retired partners, particularly those who were members of large partnerships, to determine how much of their income was taxable in every state in which the partnership earned income is difficult at best, impossible at worst. Add to this the fact that most retired partners reasonably believed that they were covered by HR 394 and never filed returns outside of their state of residence. These retired partners have no statute of limitations protection. It is ten years since HR 394 was enacted, and states could require nonresident returns to be filed for all prior years, creating a substantial compliance burden in terms of tax and interest, and the cost of preparing nonresident tax returns. The statute of limitations trap is exacerbated by the fact that retired partners who reside in a state that imposes an income tax can only claim a refund for nonresident taxes paid within the resident state's statute of limitations, generally three years. Nonresident taxes that are assessed outside of this period will provide no resident state tax relief, resulting in double taxation for the entire amount of nonresident tax assessed. This is a burden that had not even been contemplated when the law was passed.

Another burden involves determining how much of the retired partner's pension income is allocable to a particular state. One state is presently considering employing two alternative methods, depending on whether the retired partner's interest in the partnership is totally

liquidated. If the interest is not totally liquidated, then the state intends to allocate the retirement income by the allocation percentage of the partnership itself for the current year. If the interest is liquidated, then the amount allocated to the state is based on where the partner performed his or her services prior to retirement, using the ratio derived from dividing the number of days services were performed in the state during the portion of the retirement year plus the prior three years, by the total number of days services were performed everywhere during the same period.

Neither of these methods is reasonable. In the first instance, since the retired partner performed no work for the partnership during the taxable year, how can the partnership's allocation percentage be relevant? Under the second method the problem of finding and defending the number of days worked years in the past is virtually an insurmountable burden. Worst of all, each state that determines that partners are not exempt individuals may devise its own allocation formula. We could easily be looking at 30 or more states for which data would have to be gathered and the proper formula applied. This is precisely the type of burden the Act was designed to avoid.

As to double taxation, it is clear that retired partners who may have earned income in as many as thirty states during their active tenure could be responsible for taxes in all of these states. This raises the possibility they will pay state taxes on more than one hundred percent of their retirement income.

State administrators point to the fact that the states generally allow a credit for taxes paid to non-domiciliary states. They must also agree, however, that this does not eliminate the problem. Most states, if not all, allow the credit only up the amount that would be subject to tax under their laws. For example, if I am a resident of a state that imposes its tax at the rate of five percent, and a state that imposes its tax at the rate of ten percent also taxes my retirement income, I will pay ten percent to that non-resident state, but only receive a credit by my resident state equal to five percent of that amount. Also, some states will not allow a credit to its residents for a tax that they do not impose on its nonresidents, or do not believe is valid. And, of course, retirees

who live in states that do not impose an income tax will receive no relief from paying tax to other states when there is no offset to be had. Finally, there may be little or no concomitant federal tax relief for these multiple payments due to the Alternative Minimum Tax.

. An example of the difficulties of calculating the amounts owed is attached to this testimony. It would be necessary to estimate the amount a state could assess on audit for each open year and the maximum credit available to be claimed against the tax in the resident state. Further, the schedule would need to be updated periodically as the states assess and collect the tax. In the attached schedule, a retired partner resident in New Jersey had, in the 2001 tax year, a total of $18,826.06 of state taxable income attributable to 34 different states. His state tax would total $1,192.49 but based on state rules, only $1,040.58 would be creditable. It is clear that the credit mechanism does not solve the problem of double taxation. Further, retired partners who, in 2001 were residents of Pennsylvania, Illinois, Mississippi or Hawaii would receive no credit since those states did not tax pension income.

How can these problems be solved? The answer is to enact HR 4019. This bill clarifies HR 394 by specifically stating that retired partners are included. Further, it makes it clear that the language requiring that payments from non-qualified plans must be "part of a series of substantially equal periodic payments (not less frequently than annually)" does not preclude such plans from the exemption based merely upon caps or limits based on a predetermined formula or on adjustments such as cost of living increases. Most importantly, since it is a clarification of existing law, rather than a change in the law, HR 4019 is applied retroactively to the December 31, 1995 date that HR 394 was enacted. With the passage of HR 4019, Congress will have assured that the problems that necessitated the enactment of HR 394 are solved for all retirees.

Thank you for your time and consideration of this important issue.

Attachment:

2001 Adjusted Schedule I.PDF

PRICEWATERHOUSECOOPERS

**State of Residence:** NJ

## Adjusted 2001 Schedule I

| | State Taxable Income | State Tax | Creditable Tax |
|---|---|---|---|
| Alabama | 97.52 | 4.88 | 4.88 |
| Arizona | 0.00 | 0.00 | 0.00 |
| Arkansas | 2.93 | 0.21 | 0.19 |
| California | 3,400.07 | 316.21 | 216.58 |
| Colorado | 315.11 | 14.59 | 14.59 |
| Connecticut | 618.33 | 27.83 | 27.83 |
| Delaware | 40.40 | 2.40 | 2.40 |
| Georgia | 972.05 | 58.32 | 58.32 |
| Hawaii | 66.02 | 5.61 | 4.21 |
| Idaho | 46.23 | 3.61 | 2.95 |
| Illinois | 1,612.87 | 48.39 | 48.39 |
| Indiana | 171.66 | 5.84 | 5.84 |
| Kansas | 9.20 | 0.59 | 0.59 |
| Kentucky | 88.51 | 5.31 | 5.31 |
| Louisiana | 94.50 | 5.67 | 5.67 |
| Maine | 33.43 | 2.84 | 2.13 |
| Maryland | 305.70 | 14.67 | 14.67 |
| Massachusetts | 1,803.46 | 100.99 | 100.99 |
| Michigan | 88.47 | 3.72 | 3.72 |
| Minnesota | 9.10 | 0.71 | 0.58 |
| Mississippi | 2.58 | 0.13 | 0.13 |
| Missouri | 404.83 | 24.29 | 24.29 |
| Nebraska | 44.22 | 2.95 | 2.82 |
| New Jersey | 0.00 | 0.00 | 0.00 |
| New York | 4,122.29 | 282.38 | 262.59 |
| North Carolina | 819.89 | 67.64 | 52.23 |
| Ohio | 702.29 | 52.67 | 44.74 |
| Oklahoma | 131.74 | 8.89 | 8.39 |
| Oregon | 154.88 | 13.94 | 9.87 |
| Pennsylvania | 1,305.90 | 36.57 | 36.57 |
| Rhode Island | 16.42 | 1.66 | 1.05 |
| South Carolina | 66.01 | 4.62 | 4.21 |
| Utah | 46.69 | 3.27 | 2.97 |
| Vermont | 5.85 | 0.56 | 0.37 |
| Virginia | 1,226.88 | 70.55 | 70.55 |
| **Total:** | 18,826.06 | 1,192.49 | 1,040.58 |

Footnote - Partners who were residents of Pennsylvania, Illinois, Mississippi, or Hawaii during 2001 will not have an additional tax credit because these states do not tax pension income.